Nos. 10784-10785

In the United States Circuit Court of Appeals for the Ninth Circuit

UNITED STATES OF AMERICA, APPELLANT

v.

CONSOLIDATED ROCK PRODUCTS CO., A CORPORATION, UNION ROCK COMPANY, A CORPORATION, AND CONSUMERS ROCK & GRAVEL COMPANY, INC., A CORPORATION, APPELLEES

ON APPEAL FROM THE DISTRICT COURT OF THE UNITED STATES FOR THE SOUTHERN DISTRICT OF CALIFORNIA

REPLY BRIEF FOR THE UNITED STATES

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ARGUMENT

The Government's argument that these items were not deductible as fixed and determined liabilities of the tax year does not raise a new issue in this court. Nor is that argument founded upon any departure from or contradiction of the record or of the findings of the court below

Part I of appellees' argument (Br. 19–24) is devoted, not to any attempt at refutation of the Government's statement that the taxpayer was currently insisting that it had no fixed and determined liability to its subsidiaries with respect to these items, nor to any effort to dispute the proposition that *only* fixed and determined liabilities may be deducted by a tax-

payer on the accrual basis; the appellees say merely that there is no evidence to support the Government's contention, and that in making the argument the Government is seeking at this late date to inject an entirely new issue into the case—which it may not do. We answer that the issue of whether these items were proper accruals of the taxable year[1] *was* presented to the court below; that the taxpayer has all along been apprised of our position; and that the Government's argument on the point has solid evidentiary foundation. Nor does that argument in anywise conflict with the trial court's findings.

It should be kept constantly in mind that the instant controversy has its setting in a reorganization proceeding involving the taxpayer corporation and two of the seven subsidiary corporations to which it *presently* alleges that it was unconditionally liable in 1938 for the amounts here in question; the tax claim which is the subject matter of this appeal was filed directly *in* the reorganization proceedings (R. 35) and was heard, considered, and denied, as a *part* of those proceedings (R. 282–285). The "record" in the case at bar is accordingly a part of the "record" of the reorganization; and the converse of the proposition is equally true. Furthermore, the Government expressly *made* the developments in the reorganization proceedings a part of its case. For example, in our brief filed

[1] Assuming, *arguendo*, that they were "business expenses" of the parent corporation within the meaning of Section 23 (a). The discussion of the Government's contention that they were capital contributions to the subsidiaries and not "business expenses" of the parent comprises Part II of our opening brief.

below, we specifically called the attention of the court to its order continuing the debtor in possession of the properties and providing that the operating agreements should remain in effect.[2]

It will be recalled that the taxpayer had petitioned for reorganization in 1935; that in 1937, the year prior to the taxable year here concerned, the taxpayer had submitted a plan of reorganization to the court below; and that objections were filed thereto by certain bondholders of the two petitioning subsidiary corporations. These bondholders *inter alia* questioned the asset position of their debtor corporations as set forth in the plan, and were insistent that an appraisal be made. The taxpayer's answer in part was that by reason of the operating agreements, its properties and those of its subsidiaries had become so intermingled that segregation and separate appraisal was impossible; and the court below specifically found to that effect when it confirmed the plan in 1938.[3] See *Consolidated Rock Co.* v. *Du Bois,* 312 U. S. 510, 518. This finding by the trial court would seem affirmatively to support our position that the items here in question were not proper accruals of the year 1938.

[2] We argued that neither the terms of the operating contracts nor anything in the court order showed these items to be unconditionally due in the taxable year. The pertinent excerpt from our brief in the trial court appears at a later point in this discussion.

[3] The court did not make any finding with respect to the amount or validity of the inter-company claims arising from the operating agreements; it concluded that any liability thereunder was not for the benefit of third persons, including the bondholders. The proceedings before the trial court in respect to the reorganization plan appear in *In Re Consolidated Rock Products Co.* v. *Union Rock Co.* (S. D. Cal.), No. 25,816–H.

In any event, it quite definitely contradicts the later conclusion and order of the trial court that these items were properly deductible by the debtor corporation. The reason, of course, is that if the assets of parent and subsidiaries [4] were so inextricably commingled as a result of the operating agreements as to defy segregation, then it was also impossible to ascertain what amount of depreciation, etc., if any, the property of the respective subsidiaries had suffered in the year 1938. Accordingly, bearing in mind the taxpayer's present contention that the amount of the subsidiaries' depreciation, etc., was a measurement of its so-called "rental" liability to them, it becomes at once apparent, we submit, that on this finding the taxpayer did not have any determined or determinable liability to its subsidiaries during the pertinent tax period.

However, we pass this point in order to consider the further course of these reorganization proceedings in the light of appellees' complaint that we are raising a new issue on this appeal, and an issue which not only goes beyond the evidence but actually contradicts the trial court's findings. The instant claim for taxes was filed in these reorganization proceedings in February of 1942; in 1940, this Court had reversed the District Court's confirmation of the plan of reorganization submitted by the taxpayer, the decision of reversal containing [5] the following significant paragraph:

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[4] Only two of the seven subsidiary corporations were involved in the reorganization proceedings. It is to be noted, however, that the taxpayer's position here is the same with respect to *all* of the subsidiaries. See R. 272.

[5] *In Re Consolidated Rock Products Co.*, 114 F. 2d 102, 104.

> The debtor's books showed that it owed Union and Consumers about $5,000,000, *the validity and amount of such debt being disputed by the debtor.* (Italics supplied.)

And, as we pointed out at some length in our opening brief (p. 16–18), the taxpayer continued to dispute the validity and amount of "such debt" when the Supreme Court took the case on certiorari and in 1941 upheld this Court's decision that the proposed plan should not have been approved. Thus, at the time of decision by the trial court in respect of the instant controversy, which was in June of 1943 (R. 262), the decision of this Court and of the Supreme Court as well as the taxpayer's briefs filed in support of its plan—all containing unambiguous evidence of the taxpayer's denial of obligation to its subsidiaries—were a part of the "record" in the reorganization case. Again, the taxpayer appears conveniently to forget that the tax claim at bar is not an isolated matter which can be insulated from the proceedings of which it is an integral part; the taxpayer would like to ignore, and to have this Court ignore, the fact that to the very court which heard the instant controversy and to two courts of review, the taxpayer had continuously urged that the operating agreements created not certainties but *uncertainties.* The taxpayer has not been misled; instead, we submit, it is the taxpayer who seemingly has sought and still seeks to mislead.

It may perhaps be true that the Government did not specifically argue below that the taxpayer was making an "about-face" with respect to the definite-

ness of these liabilities. The briefs filed in the trial court do not disclose that that particular argument was made in connection with the issue of whether these liabilities were definite and certain in fact and amount so as to be proper accruals of the taxable year. But although the taxpayer apparently perceives no distinction, there is certainly a vast difference, we submit, between making a new *argument* and raising a new issue in an appellate court. And the *issue* of the "certainty" of these liabilities clearly was presented to the District Court and was before it for consideration. The Government's brief below is ample proof that our case for disallowance of the deduction did not rest alone upon the contention that these items were not business expenses of the taxpayer within the meaning of Section 23 (a); our case was bottomed as well upon the assertion that even if the amounts *could* be so classified, they were not proper deductions of the year 1938 because they were not fixed and unconditional liabilities of that period. We quote from page 12 of the Government's brief below—

> Furthermore, even assuming that the debtor may deduct the amounts as "Expenses", it is not clear that as of the taxable year in question, namely 1938, any "Expenses" of this category were incurred. The debtor reports its income for the taxable year upon the accrual basis. It may deduct "Expenses" only if they accrue, that is, as they unconditionally become due. There is nothing in the operating agreements or the modification of the operating agreements

or the court order[6] indicating that any obligation of the debtor as to depreciation became unconditionally due in 1938. * * * The tenor of all three of these documents is that upon the termination of the operation of the subsidiaries by the debtor, then and at that time some arrangement may be reached as to the credit, if any, to be given the subsidiaries by the Operating Company on account of the depreciations of their property.[7] The debtor

[6] This is the reference in our brief below to which we previously adverted in stating that the Government had specifically called the developments in the reorganization proceedings to the trial court's attention; which by implication at least pointed out that the taxpayer had made an "about face" with respect to the definiteness of the liabilities in question.

[7] It is interesting to note that although, in connection with its proposed reorganization plan, the taxpayer urged and the Supreme Court indicated in its *Du Bois* opinion, *supra*, that the modification agreement was in effect, the taxpayer in connection with the matter at bar urges and the District Court found (R. 274) that the modification agreement never became operative. While the point is not *per se* material, it further evidences not only the fact that the taxpayer follows that course which best serves its self-interest at the particular moment, but also it shows plainly the trial court's seemingly complete indifference here to the views of the two courts which had reviewed its previous decision.

And again: The taxpayer's instant brief to this Court is studded with denials (Br. 4, 25, 27) that it was "operating" the subsidiaries—such denials being in support of its present contention that the depreciation, etc., suffered by the subsidiaries was only a measurement of taxpayer's "rental" liability to them. But the Supreme Court's *Du Bois* opinion contains statements which can hardly be reconciled with these denials. Thus, at page 523 of the Supreme Court's opinion it is declared—

"There has been a unified operation of those several properties by Consolidated pursuant to the operating agreement. That operation not only resulted in extensive commingling of assets. All management functions of the several companies were assumed by Consolidated. The subsidiaries abdicated. Consolidated operated

> is in a 77–B proceeding. All its agreements and actions are subject to the veto of the court. Unless and until the court issues an order as to depreciation, if any, to be allowed as a credit to the subsidiaries on account of the use of their properties by the debtor, no liability for depreciation arises on the part of the debtor. No such order was issued by the court during the taxable year. [Italics supplied.]

Moreover, the taxpayer in anticipation of the Government, declared in its opening brief below (p. 18)—

> It is submitted that the real issue in this proceeding is whether or not at the end of 1938 the debtor has incurred *definite* liabilities to its subsidiaries for the use of their properties * * *. [Italics supplied.]

Taxpayer's principal argument on the point, as reflected in its brief to the trial court, was that liability was "definite" merely because the amounts here under consideration were set up on the taxpayer's books as an unconditional liability to pay and upon the subsidiaries' books as an unconditional right to receive. And it would appear that the trial court adopted this argument; in any event, it found, as the taxpayer points out (Br. 21), that the respective corporate book entries were made as "unqualified" accruals. But, of course, no citation of authority is needed to support the proposition that book entries must stand or fall on the truth of their content; they can rise no higher

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them as mere departments of its own business. Not even the formalities of separate corporate organizations were observed, except in minor particulars such as the maintenance of certain separate accounts."

than their source. If the items here in question were *not* liabilities which were definite and certain in the taxable year, "evidence" to the contrary appearing on the taxpayer's or on the subsidiaries' books of account will not make them what they were not. It is to be noted that the taxpayer in the case of *Dixie Pine Co.* v. *Commissioner,* 320 U. S. 516, which we cited in our brief in chief (p. 19) as dispositive of the issue now before this Court, was also "accruing" the amount of the state tax upon its books as an unqualified obligation—while vigorously contesting any liability to pay it. The Government does not, as the taxpayer urges (Br. 4), "contradict" the trial court's findings when it maintains here that the taxpayer could not deduct items on which it was denying liability—irrespective of the "unqualified" manner in which the amounts were posted. That is a totally irrelevant consideration under the circumstances of this case; the controlling factor here is that unless and until the taxpayer ceased to deny liability to its subsidiaries [8] or unless and until the matter was authoritatively adjudicated against it, the obligation was not fixed and determined within the meaning of the federal revenue laws. *Dixie Pine Co.* v. *Commissioner, supra,* and cases cited therein.

[8] The taxpayer argues (Br. 20) that the Supreme Court in the *Du Bois* case "had nothing before it subsequent to September 8, 1938, when the Trial Court confirmed the plan under attack"; the taxpayer implies that between September 8th and the close of the taxable year, it might have *admitted* liability for aught that appears in the record. But we submit that when once the denial is shown, *proof* of cessation would certainly be required as foundation for a deduction claim.

And as we have shown, the Government has constantly maintained, from the very outset of this case, that the taxpayer's liability was *not* fixed and determined in 1938; the correctness of that assertion is, and always has been, one of the two legal questions or issues involved here. It is no "new issue" in the case. We are now doing no more than giving additional support to that assertion by *argument* that since the taxpayer was currently denying liability, there was every possibility that it would not, and therefore no "certainty" in 1938 that it ever would, pay its subsidiaries in any amount. The legal conclusion which we ask this Court to reach is precisely the same as we sought below: In the absence of "certainty" of obligation, deduction cannot be allowed.

We have amply demonstrated, we believe, that there is no attempt by the Government to introduce any issue in this Court which was not presented to or considered by [9] the court below. Nor do we make any contention before this Court with respect to matters of which the taxpayer is not already fully aware, or of which it has not been heretofore apprised with more than the "fair certainty" which it asks on authority of *General Utilities & Operating Co.* v. *Helvering,* 296

[9] The taxpayer contends (R. 22) that the trial court's memorandum of conclusions shows that the "legal conclusion urged by" the Government was not presented or passed upon below. However, the paragraph of the memorandum to which the taypayer refers states only (R. 263–264) that the *principal* contention made by the Government was that these items were capital contributions from parent to subsidiaries; by implication, this paragraph alone affirmatively shows that the Government had another ground for disallowance of the deduction claim.

U. S. 200.[10] We think that this Court will appreciate that the taxpayer at bar is really urging the proposition that a litigant can make on review only the identical *arguments* which it advanced in support of its case to the court of first instance; we believe that this Court will rightly refuse to consider any such "new issue" of procedural law.

Respectfully submitted.

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FEBRUARY, 1945.

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[10] See Paragraph III of "Statement of Points Upon Which Appellant Will Rely Upon Appeal From Order of October 30, 1943" which states (R. 288):

The District Court erred in its Order of October 30, 1943, in failing to hold that no obligation on the part of the debtor, Consolidated Rock Products Company, to meet the depletion, depreciation or amortization of leaseholds sustained by the so-called owning companies had accrued during the taxable year 1938. And cf. *General Utilities & Operating Co.* v. *Helvering*, *supra*.

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